

## 1270.01 Reporting on Evaluations of Internal Control Structures

Issued January 1, 1994

SUBJECT: Reporting on Evaluations of Internal Control Structures

APPLICATION: Executive Branch Departments and Sub-units.

PURPOSE: Provides a procedure for reporting on evaluations of departmental internal control structures.

CONTACT AGENCY: Office of Financial Management (OFM).

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SUMMARY: Public Act 431 of 1984, as amended by Act 272 of 1986, requires the State Budget Director, in consultation with the auditor general, to develop a general framework and a **system of reporting** for use by the principal departments in performing and reporting on evaluations of their internal control system. The Act also requires that each principal department must establish and maintain an internal control structure (i.e., Internal Accounting and Administrative Control Systems) using generally accepted accounting principles and directives of the OFM. This directive is set forth in the document titled "Evaluation of Internal Controls - A General Framework and System of Reporting." The General Framework prescribes periodic and ongoing monitoring of the system in order to maintain ongoing assurances about continued effectiveness of the internal control structure and to identify the need for changes.

Act 431 also requires the head of each principal State department to issue a report to the Governor, the Office of Auditor General (OAG), the Senate and House Appropriations Committees and State Budget Officer/DMB Director summarizing results of its evaluation of the department's internal control structure. The report is due on May 1 (of each odd number year) based on an evaluation of the system as of September 30 of the preceding year. For the period reviewed, the report shall include, but not be limited to, both of the following:

- A description of any material inadequacy or weakness discovered in connection with the evaluation of the department's internal accounting and administrative control system as of September 30 of the preceding year and the plans and a time schedule for correcting the internal control system, described in detail.
- A copy of the Internal Audit Activities report as prescribed in Procedure 1270.06 issued for the same period.

A department's evaluation (regardless of the evaluation tools used and internal reports maintained) must provide the basis for departmental leadership to conclude whether the internal control structure has been designed to prevent, or to detect, potential risks and whether controls are working as prescribed. As detailed in the general framework, the components of an internal control structure include the overall control environment, risk assessment and control activities; information and communication systems; and control monitoring techniques. These internal controls must provide reasonable assurance that measures are being used to:

- Develop reliable financial reports.

- Promote effective and efficient operations, including the safeguarding of State assets.
- Encourage compliance with applicable laws, rules and regulations (including prescribed managerial policies).

As noted previously, the department director must prepare and submit an external report (every two years) summarizing the results of its internal control evaluation process. Any material inadequacy or weakness discovered in connection with the evaluation must be described as well as time schedules for correcting the material deficiencies.

While it is not feasible to prescribe a definition for "materiality" in quantitative terms to be applied to all state agencies in evaluating materiality of an internal control weakness, the following attributes should be taken into consideration:

- Adverse consequences that could result from the control weakness.
- Potential exposure to those adverse consequences.
- The chance of an adverse consequence actually occurring.
- Likelihood of an actual adverse consequence being detected on a timely basis.

Qualitative attributes of errors or misstatements make certain activities material regardless of their associated dollar amounts, such as:

- Legal violations, even small ones, generally are considered material.
- Fraud, since the presence of fraud can grow into an enormous risk exposure unless preventive actions are taken.
- Transactions involving related parties.
- Sensitive payments.
- Regulatory Issues.

The act prescribes duties and responsibilities of the department director and internal auditor. Department directors and internal auditors must be familiar with Section 486 of Act 431 as amended. Internal auditors should be familiar with appropriate professional literature for performance of the duties enumerated in Subsection (4).

Care must be taken to avoid maligning the character of person(s) involved solely on the basis of unsubstantiated allegations or rumors.

APPLICABLE FORMS: None.

PROCEDURES:

### **Completing the Biennial Internal Control Structure Evaluation Report**

Designated Senior Official:

- Directs evaluation of the department's internal control structure in accordance with guidelines set forth in the General Framework issued by DMB.
- Obtains letter of assurance to department director from head of activity level owner (EXHIBIT A).
- Decides which internal control weaknesses are material and should be reported.
- Prepares comment letter to department director (EXHIBIT B).

Internal Auditor:

- Conducts review of evaluation to determine whether evaluation of internal control structure has been performed in accordance with the DMB general framework guidelines and has been carried out in a reasonable and prudent manner, and submits report to department director (EXHIBIT C).

- Reviews letter of assurance and comments on the evaluation of the department's internal control structure.

Department Director:

- No later than May 1 (of each odd number year), the department director prepares a letter to the Governor on departments internal control structure as of September 30 of the preceding year and reviews conducted by Internal Auditor. The report shall include a description of any material inadequacy or weakness discovered in connection with evaluation of the department's internal control structure. Plans and time schedules for correcting the internal control structure shall be included. The report shall provide detail and include a list of each audit or investigation performed by the department's Internal Auditor since the last reporting period (EXHIBIT D). Copies shall be sent to the following:
  - Auditor General
  - Senate and House Appropriations Committees
  - Senate and House Fiscal Agencies
  - DMB Director
  - State Budget Director

EXHIBIT A

EXHIBIT B

EXHIBIT C

EXHIBIT D

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Procedure Update: 11-9-01

Procedure 1270.01